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CONTESTED TERRAINS

The RBA (Reserve Bank of Australia) Review 2023: A missed opportunity

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Abstract

The 2022–2023 review of the Reserve Bank of Australia, published in March 2023, was a missed opportunity to reconsider the currently dominant framework for monetary policy. This framework, based on strong central bank independence and reliance on adjustments to central bank interest rates to achieve a 2–3% inflation target, has performed poorly at a global level and is no longer sustainable. A new framework, accepting a higher average rate of inflation and taking explicit account of the objectives of full employment and economic prosperity, is needed.

Keywords: inflation; Reserve Bank Review; unemployment

Introduction

In July 2022, Australia's Treasurer Jim Chalmers announced a Review 'designed to ensure that Australia's monetary policy arrangements and the operations of the Reserve Bank continue to support strong macroeconomic outcomes for Australia in a complex and continuously evolving landscape.' (Hon Chalmers 2022). The Review Committee, made up of two Australian and one UK economist, submitted its report in March 2023 (Reserve Bank of Australia [RBA] Review Panel 2023).

Unfortunately, if unsurprisingly, the public discussion surrounding the Review focused on events and policy actions of the recent past, rather than on a broad reconsideration of monetary policy arrangements. Attention was particularly focused on the unexpected upsurge in inflation following the end of COVID-related restrictions.

Like other central banks, the Reserve Bank responded by increasing its target interest rate (the 'cash rate'), an increase which flowed through to home mortgage interest rates. Unfortunately, the Governor of the Bank, Philip Lowe, had stated that no increase was likely before 2024. This erroneous prediction raised doubts about the competence of the governor and the bank's staff.

By contrast, less public attention has been paid to the decline of unemployment and underemployment rates to levels not seen since the early 1970s, when the long post-war boom came to an end. Little attention was paid to the fact that the settings of monetary policies implied a rapid end to this period of widespread prosperity.

In the end, the Review Committee had little substance to say about monetary policy. Its recommendations were focused primarily on governance issues, most notably the establishment of a separate monetary policy board.

Implicit in the framing of the report was the assumption that to the extent that the policies of the Reserve Bank match those of other central banks in rich countries, these policies should be presumed to be soundly based. The dominant policy framework of inflation targeting based on interest rate adjustments, which has been in place since the early 1990s, was not questioned. This complacency is surprising given the multiple failures of monetary policy in the decades since the current policy framework was established.

The current framework

The RBA Act requires the Reserve Bank to exercise its powers 'in such a manner as, in the opinion of the Reserve Bank Board, will best contribute to:

(a) the stability of the currency of Australia;
(b) the maintenance of full employment in Australia; and
(c) the economic prosperity and welfare of the people of Australia.'

More briefly, these objectives may be specified as referring to inflation, employment, and national income. Regardless of the policy framework adopted by the bank, the operation of monetary policy requires a judgement as to the appropriate level or rate of growth of these variables.

The current monetary policy framework in Australia was adopted in the 1990s, at the same time as in most developed countries. Its key features are strong central bank independence, inflation targeting, and a non-accelerating inflation rate of unemployment (NAIRU)-based interpretation of 'full employment'.

Inflation

Under the inflation-targeting policy in place since the 1990s, the RBA sets out an explicit interpretation of the price stability objective. This means that the rate of inflation, as measured by the consumer price index, should be maintained at an average rate of 2% to 3%.

The rationale for this choice is historical rather than theoretical. According to the RBA Explainer (2023 4):

> The 2 to 3 per cent target range is sufficiently low that inflation at this level does not significantly influence people's economic decisions. This target range was set in the early 1990s when inflation of around 2 to 3 per cent had already been achieved. It was decided that inflation should be kept at around that rate, given the fact that the lowest average inflation rate experienced by other countries had, over many years, been a little over 2 per cent. At these levels of inflation, an economy can achieve sustainable growth in output and employment.

Unemployment

By contrast, there is no explicit target for employment or unemployment. Monetary policy is guided by the expectations-augmented Phillips curve model, proposed by Friedman (1968) and Phelps (1968). In this model, monetary policy has no long-term effect on the rate of unemployment, which is determined by conditions in the labour market. The rate of unemployment at which actual and expected rates of inflation are equal is referred to as the NAIRU.

When the rate of unemployment falls below the NAIRU, wages increase more rapidly than is consistent with stable inflation. The rate of inflation increases. As expectations adjust, if unemployment remains low, inflation accelerates. The process ends either in

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hyper-inflationary collapse or with the adoption of a contractionary monetary policy, which increases unemployment temporarily above the NAIRU, until inflation declines.

In this framework, the short-term benefits of reducing unemployment below the NAIRU are outweighed by the costs of the necessary subsequent deflation. It follows that the achievement of the inflation target, on average, will come as close as possible to the goal of maintaining full employment.

Economic prosperity and welfare

Australian workers are currently experiencing decreasing real wages, following a long period in which the wage share of national income has fallen. The RBA has focused almost entirely on nominal wages, considered as a determinant of inflation. While inflation was below the target range, policy statements favoured faster wage growth. However, now that inflation is above the target range, the RBA has opposed nominal wage increases, even those required to maintain the real purchasing power of wages.

Strong central bank independence

Before the 1990s, the Reserve Bank was independent in the sense that the treasurer could not direct its operations (apart from the 'nuclear option' of an official statement to Parliament). However, it was generally assumed that fiscal and monetary policy would work together on the basis of co-operation within the 'official family'. In this context, there was little surprise when Treasury Secretary Bernie Fraser was appointed as Governor of the Reserve Bank.

The critique of Keynesian fiscal policy, put forward first by Chicago economists such as Milton Friedman and then, in a stronger form, by the 'rational expectations' school, led to the emergence of a new orthodoxy in which responsibility for macroeconomic stabilisation was assigned to monetary policy. Fiscal policy was aimed at stabilising debt over the course of the economic cycle. This allowed some role for automatic stabilisers, but active fiscal stimulus was deprecated and reductions in public debt were seen as a high priority.

In this context, an independent central bank was seen as a check on irresponsible government policy, or more charitably as a signal of commitment to responsible fiscal policy. The cooperative approach was replaced by a formal agreement between the treasurer and the RBA Governor. The first Statement on the Conduct of Monetary Policy was issued in 1996, and it has been updated periodically since then.

As Blinder (2012) observes, central bank independence works well, except in the context of an economic crisis. But this is damning with faint praise. Crises are precisely the time when the conduct of macroeconomic policy matters most. Moreover, the aftermath of crises constrains policy for many years. The recovery from the global financial crisis was incomplete when the COVID-19 pandemic emerged a decade later. The inflationary shocks arising from the pandemic and the (necessary) policy responses are likely to dominate macroeconomic policy for years to come.

International experience

While Australia's experience of inflation-rate targeting has been relatively benign, this experience is exceptional. Although the regime worked reasonably well in establishing low inflationary expectations in the 1990s, performance since then has been poor in most OECD countries. For most of the period following the Global Financial Crisis (GFC), the system was operating under emergency conditions, with key central banks held at or no zero. Attempts to raise rates were repeatedly abandoned when they threatened to cause a

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relapse into recession. Poor economic outcomes have given rise to political failure, notably including the rise of far-right populist movements in many countries.

Australia's relatively good performance may be explained by a number of factors. First, the financial crisis and deep recession of 1989–91 produced a degree of immunisation against the speculative excesses of the early 21st century. Second, Australia adopted, and mostly sustained, large-scale fiscal stimulus in both the GFC and COVID emergencies. Finally, Australia benefited from export demand from China, which also adopted and sustained fiscal stimulus. However, most of these factors were one-off and will not be repeated in future.

What needs to change

The target rate of inflation

Whether explicitly or otherwise, monetary policy must embody a view on the desirable rate of inflation, around which variations may be managed. The current target of 2–3% was not chosen on the basis of a welfare calculation but rather on pragmatic judgements based on the circumstances of the late 20th century.

There are two main arguments for a higher target rate. First, experience has shown that the use of a 2–3% target for inflation implies that the desired nominal target rate (in Australia's case, the cash rate) will regularly fall below zero. This is because:

(a) the neutral real rate of interest has fallen steadily and is now close to zero; and

(b) under inflation targeting, expansionary monetary policy is required precisely when the rate of inflation falls below the target range

To illustrate, suppose that the rate of inflation is 1% and the real neutral rate is also 1%, so the nominal neutral rate is 2%. In these circumstances, the cash rate can be no more than 2 percentage points below the neutral rate, which is insufficient.

It is therefore necessary to rely on open market operations ('quantitative easing') as the primary policy for expansionary monetary policy. Among many other problems, the introduction of a deliberate asymmetry between expansionary bond purchases and contractionary increases in interest rates seems likely to generate large losses for central banks, as we have observed.

A further difficulty is that low and stable inflation has been associated, historically, with high and unstable asset price inflation. As Borio and Lowe (2002, Abstract) observed:

> . . . financial imbalances can build up in a low inflation environment and that in some circumstances it is appropriate for policy to respond to contain these imbalances. While identifying financial imbalances ex ante can be difficult, this paper presents empirical evidence that it is not impossible. In particular, sustained rapid credit growth combined with large increases in asset prices appears to increase the probability of an episode of financial instability. The paper also argues that while low and stable inflation promotes financial stability, it also increases the likelihood that excess demand pressures show up first in credit aggregates and asset prices, rather than in goods and services prices. Accordingly, in some situations, a monetary response to credit and asset markets may be appropriate to preserve both financial and monetary stability.

Given the central role of home ownership in Australian household wealth, the RBA has found the management of this dilemma particularly difficult, despite the prescience of its governor. High interest rates have been criticised for the burden they place on homebuyers, while low interest rates have been criticised for inflating perceived housing bubbles. These difficulties are inherent in the current policy framework and do not reflect the competence of the RBA.

Given the current high inflation rate, a move to increase the target rate is urgently needed. The use of contractionary policy to reduce inflation is always risky. An attempt to drive inflation down to the 2–3% range is highly likely to generate an avoidable recession.

The main issue in adopting a higher inflation target, say 4–5%, is credibility. But under current circumstances, a commitment to such a target range is more credible than an aspiration to return to 2–3%.

The choice of target variable

The adoption of a focus on inflation alone is theoretically justified by a 'natural rate' model, that is, one in which the NAIRU is determined entirely by the structure of the labour market and is unaffected by monetary policy. Models of this kind were widely accepted in the early 1990s.

Since then, however, it has become evident that monetary contraction has sustained effects on both labour markets (hysteresis) and on the medium-term growth path of the economy. In these circumstances, an inflation-targeting regime is likely to lead to suboptimal outcomes.

The most commonly suggested alternative is nominal gross domestic product (GDP) targeting. However, this is inappropriate for Australia because of our exposure to large swings in the terms of trade. Hence, some form of nominal income targeting may be preferable.

More generally, while maintaining a targeting regime, it is desirable to take non-target variables into account. In the Australian context, it is already clear that policy is constrained by concerns about the stability of the housing market (the analysis of Borio and Lowe, cited above, is relevant here). On the other hand, little explicit attention has been paid to the full employment objective.

Policy instruments

With a broader set of targets comes the need for more policy instruments. In addition to interest rates and open market operations, central banks have made increasing use of a variety of constraints on lenders and borrowers, justified by the need for macroprudential policy. These instruments should be used more broadly, in particular, to deal with asset price inflation separately from general inflation.

Explicit commitment to full employment and living standards

The current policy framework starts from the NAIRU-based presumption that achievement of low and stable inflation will lead, more or less inevitably, to the best feasible outcomes in terms of the second and third objectives set out in the RBA Act: full employment and improving living standards. This has manifestly not been the case in Australia or globally during the era of inflation targeting.

An extreme example is provided by the European Central Bank (ECB) under the leadership of Jean-Claude Trichet. As Trichet (2011) observed, the ECB delivered the objective of price stability 'impeccably'. Despite this, the Eurozone experienced an economic downturn comparable to the Great Depression. Only the abandonment of Trichet's policies by his successor Mario Draghi prevented complete collapse.

Experience in Australia has been more favourable, but low inflation has not delivered either full employment or the improvements in living standards that could reasonably be expected on the basis of observed technological progress. An explicit recommitment to full employment and improved living standards is needed.

What the Review Panel recommended

For the most part, the Review Panel failed to address substantive issues regarding the design of monetary policy. After conceding the strength of arguments for a higher inflation target, the Panel's report stated:

> Regardless of the merits of higher inflation in general, the Review does not recommend increasing the inflation target during the present period of high inflation. To do so could undermine the credibility of the RBA in responding to future periods of above-target inflation (RBA Review Panel 2023 84)

This concern with credibility is characteristic of dominant central bank orthodoxy. There is little evidence that credibility actually enhances the effectiveness of monetary policy. Moreover, the bank has substantially lost credibility with previous failures to reach the inflation target, but this has not prevented a substantial reduction in inflation following recent tightening of policy.

The Panel is similar with respect to suggestions that the failed regime of inflation targeting should be replaced by some form of nominal income targeting. Again, there is no serious attempt to assess the evidence. The Panel devotes a single paragraph to its analysis, stating (RBA Review Panel 2023 84):

> While some research suggests that alternative frameworks such as nominal income targets would be better suited, the Review did not find sufficiently strong evidence to support a switch to an alternative framework. The bulk of the consultations conducted by the Review supported the flexible inflation target framework because it had performed well and was understood by the public. Alternatives that introduce 'make-up' strategies or nominal income targets may perform well in particular circumstances, but they also have disadvantages relative to flexible inflation targeting.

By contrast, the report devotes considerable attention to governance issues, including the frequency of meetings and communication of decisions.

Concluding comments

Australia's economic performance has been reasonably strong over the period of inflation targeting, partly because of the successful use of fiscal policy during the GFC and COVID-19 lockdowns. Globally, however, inflation targeting has been a clear failure. The GFC was followed by a long recession from which recovery took years. Central bank interests hit the zero lower bound and stayed there for many years. Inflation has been persistently outside the arbitrarily chosen 2–3% range.

For central banks, on the other hand, the shift to inflation targeting and strong central bank independence has been a source of increased power and prestige. It is unsurprising that central banks in Australia and elsewhere should seek to maintain an inflation-focused policy that has been so rewarding for them. But for those who care more about real outcomes like employment and economic welfare, the need for a serious reassessment of the current framework is evident. Sadly, the Review has not delivered such a reassessment.

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